

# ICPS newsletter<sup>®</sup>

## Residential services sector awaits private investors

*It is getting more and more difficult for the State to bear the burden of residential services—water, heating, electricity and building maintenance—at its sole expense. As a way out of this crisis situation, private capital has to be attracted to the sector, because it can work more effectively, provided that appropriate regulation is in place. However, the need to introduce higher utility rates and other unpopular measures prevents politicians from completing the reforms already begun in this sector*

### Looking for change

Reform of residential services sector is going very slowly in Ukraine. The quality of services remains unsatisfactory and—what's more important—the proper conditions for improving the sector are not in place. With the list of objects for privatization steadily shrinking, state costs for maintaining residential services rising, and the dissatisfaction of residents with the quality of services growing daily, the stage is set for private providers to come in.

Sooner or later, private capital will come into Ukraine's residential services sector: the question is only how soon and how effectively. The sooner investors are convinced that the conditions offered by the State are carved in stone, the sooner private capital, including foreign money, will appear. At the moment, however, only locals are willing to take the risk. Given their limited financial resources and lack of experience in managing residential services, however, local providers are not the best option.

### CE countries provide an example

Central European countries have done a better job than Ukraine in reforming their residential services. Yet their systems have much in common with Ukrainian ones, and their experience reforming residential services, for which the EU provided both financing and standards, can be taken as an example.

From the very beginning, CE countries looked at privatization as the key to reviving residential services. Neither their cities nor their central governments had the money to renovate outdated infrastructure. Once large international companies came into the sector, they had enormous positive impact: they introduced

good management practices and persuaded governments to regulate utility rates using market-based methods. This was critical: the cities' lack of prior experience working with the private sector had often impeded reforms, even when the necessary legislation was in place.

In most CE countries, the appearance of an independent regulatory body in the residential services sector was one of the key elements of reform. The establishment of such an authority was conditioned primarily by the need to maintain the balance of interests between local governments and sector monopolists. However, providing such fundamental services to the general population is highly politicized, and none of these countries was able to set up a regulatory body that was completely independent of sector ministries and local authorities.

Still, as utility payments became the main source of funding for residential services,

### Residential services in Ukraine

- In 2002, nearly 7 billion UAH or 3% of country's GDP went to this sector for services.
- Residential services take up to 15–20% of the average monthly salary.
- Over 30% of waterworks and sewage systems are in a very dangerous state.

political will on the part of local officials did appear. Certain kinds of costs were cut with more effective management. Rising rates were accompanied by targeted subsidies and minimal water and gas supplies for the non-working population (the jobless, pensioners, invalids, etc.). Notably, these reforms were promoted through active information campaigns and numerous public hearings.

In Ukraine, the commercialization of this sector—that is, introducing market principles into the work of residential service providers and setting up a regulatory system—is in an embryonic state (Stage I). Moreover, Poland, Latvia, Hungary and other CEE countries found moving into the second stage not without its difficulties and the process is still not finished.

**Table 1. Main stages in transforming public service enterprises**

	natural monopolies	other residential services (public transit, waste disposal)
Stage I: Restructuring	A modest break-up of state-owned monopolies (primary separation of monopolistic assets from non-monopolistic ones) The establishment of an independent regulatory body	Definition and separation of ancillary functions Creation of conditions for competition
Stage II: Privatization	De-monopolization (privatization of units engaged in non-monopolistic activities) Development of regulatory functions Price liberalization	De-monopolization Management of public shares and assets Privatization

Source:

*Navigation to the Market: Regulation and Competition in Local Utilities in Central and Eastern Europe*

## Reforms stagnate

When compared to reforms in other infrastructure areas such as energy and telecoms, reforms to Ukraine's residential services sector are not impressive. The process of this reform is tied into the reform of local government, insofar as oblast and county administrations have become the owners of enormous physical assets. Transferring centrally-owned enterprises to local administrations also meant handing over financing, pricing and governance. Despite this decentralization of direct management of residential utilities, however, there was never any clear definition and division of functions between the center and the regions. To date, no regulatory system has been developed in this sector, either.

Among positive achievements in the sector are much-needed rate hikes for residential services, although these are still not at the necessary levels. Before 1990, most Ukrainians paid only 5% of the cost of residential services; the rest was covered by the Budget. By 1998, consumer rates reflected 80% of real costs. Unfortunately, these costs keep rising: energy prices grew and, critically, no measures were taken to improve efficiency. Thus, by 2000, consumer rates were covering only 60% of actual costs and most residential service enterprises were slipping deeper into the red.

## A new relationship

The relationship between municipalities and residential services investors can take a wide range of legal forms, the most pertinent of which are: service contracts, long-term leases and buy-outs. The choice will be determined by two major factors: current legislation (Ukraine places limitations on the privatization of certain establishments) and local conditions. The acceptability of a particular form of contractual liability also depends on the financial state of the enterprise in question.

At this time, two schemes for attracting private structures into residential services management are being considered in Ukraine: transferring waterworks (*vodokanal*) and heating plants (*teplokomunenergo*) to the management of utilities and long-term leasing.

**Integration with power utilities.** Since residential enterprises are the biggest

deadbeats with regard to power utilities (*oblenergo*) and gas companies (*oblgas*), more rigorous control on the part of their suppliers might solve the problem of timely and complete payment. Residential service providers are very dependent—and not only in Ukraine—on energy supplies. For instance, energy makes up more than 60% of all costs of supplying water. Such a scheme would solve the problems of both the energy sector and NAK Naftogaz Ukrainy. However, this scheme makes it unlikely that the long-term interests of residential service providers will be taken into account. For instance, huge energy costs can be directly connected with outdated and inefficient equipment, yet upgrading fixed assets requires substantial investment. Further merging of power utilities with residential services could also increase monopolization in this market and weaken the influence of local administrations on residential services.

**Leasing.** Long-term leases of residential service enterprises by private business is the easiest and most legally feasible way to attract investors. The main drawback is that the process of leasing these enterprises is closed to a key stakeholder, the general public. Weak public control over local officials encourages corruption and unfair competition.

## Wanted: An effective investor

By "effective", we mean able to provide an appropriate level of mutual benefit for all stakeholders: the State, the investor and the consumers. The State is mostly interested in timely, quality services, preferably without any rate increases. The investor is interested in return on the investment. Can both goals be achieved in Ukraine?

There are plenty of opportunities for cutting residential services costs: water and heat loss, sometimes as much as 50% of the total supply; overstuffed enterprises; poorly coordinated billing systems; corruption among managers; and so on. However, to introduce efficiencies in these areas, a private owner will need state support: the right to cut back staff and cut off the supply to deadbeat consumers. In short, the Government has to choose among a number of unpopular options. It is very unlikely, however, that it will make any shocking moves, especially in an election

year: no serious rate hikes, no mass staff reductions. Thus, despite the substantial benefits to be gained from cutting costs, in some regions rate hikes will be impossible to avoid. To mitigate the undesirable effects of this reform, the Government could reform the social security system and the system of utility rate regulation.

## The cities go first

Pilot projects for reforming residential services are already underway in many of Ukraine's larger cities, for a number of reasons:

- Urban residents are more used to the comforts of civilization and can afford to pay higher rates;
- Population density is higher in cities, which offers the economies of scale;
- The professionalism of urban government workers is, as a rule, higher. In addition, greater political activism among city-dwellers means that city officials are more likely to take decisive actions.

At the initial stage, local initiatives are having a positive impact. However, the lack of a unified policy and standards could result in negative consequences. Thus, both the legislative and executive branches of power must follow a policy of setting equal conditions for carrying out reforms and managing residential services in all the regions. This means the areas of responsibility of the municipalities, private owners and communal owners, and the role of the regulatory body must be clearly defined. For example, it is unlikely that private owners will worry about environmental issues or universal access, without regulation.

Growing differences among regions will make it more difficult to carry out nationwide reforms: to try to set national standards after the fact will mean revisiting locally-set standards and already-agreed contracts. Since regions differ in the level of deterioration of their physical infrastructure, access to natural resources, and political activism, the details of the reform process will differ in every specific case. ■

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